

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Aqua Illinois, Inc.

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Docket No. 14-0419

**Proposed general increase in water
rates for the Kankakee service
territory**

PUBLIC

REPLY BRIEF OF THE STAFF
OF THE ILLINOIS COMMERCE COMMISSION

Redacted material contained herein is designated as follows:

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NOW COMES the Staff of the Illinois Commerce Commission (“Staff”), by and through its counsel, pursuant to Rule 200.800 of the Rules of Practice before the Illinois Commerce Commission. 83 Ill. Adm. Code 200.800, and respectfully submits its Reply Brief in the above-captioned matter.

I. INTRODUCTION / STATEMENT OF THE CASE

Aqua Illinois, Inc. (“Aqua,” “Aqua Illinois” or the “Company”) on May 8, 2014 filed with the Illinois Commerce Commission (“Commission”) tariffs and charges pursuant to 83 Ill. Admin. Code 285.145 and Section 9-102 of the Illinois Public Utilities Act (“Act”), 220 ILCS 5/9-102. On May 27, 2014, Aqua submitted a supplemental Part 285 filing. On June 2, 2014, the ALJ issued a Deficiency Letter to Aqua. On June 11, 2014, the Commission issued a Suspension Order pursuant to Section 9-201 of the Act, 220 ILCS 5/9-201, by which the Commission suspended the proposed general increase in water

rates for the Kankakee service territory for a period of 105 days beginning with June 22, 2014, to and including October 4, 2014.

A status hearing was held on July 1, 2014 at which time a procedural schedule was set in this matter. As part of the schedule, the ALJ directed the parties to prepare a pretrial memo to be filed on November 14, 2014. Tr. 4. Pursuant to the procedural schedule, Staff filed Direct Testimony on September 4, 2014. Aqua filed Rebuttal Testimony on October 2, 2014. On October 30, 2014, Staff filed Rebuttal Testimony. On November 14, 2014, the parties submitted Pretrial Memoranda pursuant to direction of the ALJ. On November 20, 2014, a hearing was convened, and testimony taken and evidence adduced. Tr. 11-115. Staff and Aqua filed Initial Briefs on December 10, 2014. Staff's Reply Brief follows.

Aside from issues addressed in this Reply Brief, Staff stands by the positions articulated in Staff's Initial Brief. Not addressing a specific issue in this Reply Brief does not constitute a change of position from Staff's Initial Brief.

II. COST OF CAPITAL AND CAPITAL STRUCTURE

A. Cost of Debt

- 1. Cost of Short-Term Debt (Uncontested)**
- 2. Cost of Long-Term Debt (Uncontested)**

B. Cost of Common Equity

- 1. Aqua's Assertion that Staff's Return on Common Equity Methodology is Flawed and Should Not Be Adopted is Inaccurate and Inconsistent with Recent Commission-Approved Methodology**

Aqua argues that Staff's approach to determining the Company's return on common equity ("ROE") represents a significant departure from Staff's approach in

previous rate cases, undermines the notion of regulatory stability, and negatively penalizes Aqua Illinois as compared to other utilities. (Aqua IB, 22.) Aqua further argues that Staff's ROE analysis contains numerous errors and inconsistencies, fails a comparison test of alternative investment opportunities when compared to the common equity cost rate estimated for large companies, fails a comparison test of projected ROE, and fails to consider the alleged fact that if authorized, Staff's proposed 9.07% ROE will not likely be earned due to Staff's proposed adjustments. *Id.* Aqua is incorrect.

The Company's argument that it will not earn the 9.07% ROE due to Staff's proposed adjustments is without merit. The revenue requirement approved by the Commission will reflect the ROE on the rate base that the Commission determines is just and reasonable. The Company will have the opportunity to earn the approved ROE, but many factors, such as business decisions and weather, will determine if the Company earns more, at or less than the Commission approved ROE.

Aqua argues that "[t]he methodology Staff employs to arrive at its ROE proposal represents a significant departure from Staff's approach in previous rate cases. In doing so, Staff's proposal undermines the notion of regulatory stability, and negatively penalizes Aqua Illinois as compared to other utilities." (Aqua IB, 21.) This is not the case. Staff utilized the same Discounted Cash Flow and Capital Asset Pricing Model ("CAPM") it has used in numerous prior cases and the Commission has consistently relied upon. In fact, in this proceeding Staff used the same methodologies to determine Aqua's ROE as it did in Docket No. 11-0436. *See, Aqua Illinois, Inc.*, Final Order, February 16, 2012, 11-39. The Commission approved ROE in Docket 11-0436 is based on Staff's analysis. The Company's ROE here, on the other hand, is based of the

same methodology Aqua presented in Docket 11-0436, which the Commission rejected. Contrary to the Company's assertions that accepting Staff's proposal undermines regulatory stability, Staff's proposal would actually maintain that stability. Indeed, acceptance of any of the Company analysis would be contrary to the most recent Commission decision for Aqua. (Order, Docket 11-0436, 11-39.)

Aqua's claim that Staff's proposed return on common equity of 9.07% is "neither just nor reasonable" is also unfounded. (Aqua IB, 21.) The Supreme Court has articulated that, in setting just and reasonable rates, "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *Federal Power Com. v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) (*hereinafter*, "*Hope*"). In an earlier case, the Court stated:

A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties....

Bluefield Water Works & Improvement Co. v. Pub. Serv. Com. of W. Va., 262 U.S. 679, 692 (1923) (*hereinafter*, "*Bluefield*").

In the present case, Staff applied the constant growth Discounted Cash Flow ("DCF"), the non-constant growth Discounted Cash Flow ("NCD CF") and CAPM analyses. (Staff Ex. 3.00, 5). These are described in detail in Staff's Initial Brief and will not be repeated here other than to point out that Staff applied these well established approaches to arrive at what is determined to be the just and reasonable return on

common equity of 9.07%, consistent with the United States Supreme Court precedent of *Hope* and *Bluefield*.

Aqua argues that Staff's ROE recommendation is also inconsistent with Staff's testimony in Aqua's last rate case, Docket No. 11-0436 ("AQUA2012"). Aqua argues that in AQUA2012, Staff relied upon different cost models in order to reach its recommended ROE. For example, in AQUA2012, Staff solely relied upon the DCF model, but in the instant proceeding, Staff relies on both the DCF and the NCD CF models. (Aqua IB, 25.)

This criticism is not only misplaced, but disingenuous given that the Company utilized both a constant growth DCF and a non-constant growth DCF model in this case. Significantly, the decision to use a constant or non-constant growth DCF analysis is not based on past use, but on what is appropriate given the data available at the time of analysis. Staff consistently uses the non-constant DCF when the sustainability of analyst 3-5 year growth estimates is questionable and the constant growth DCF when those growth rate estimates are sustainable. At the time Staff witness Kight-Garlich conducted her analysis, the 3-5 year analyst growth rate estimates for the Gas Sample was questionable. (Staff Ex. 8.00, 6-7.) As noted in Staff's IB, the expected long-term growth of the economy ranged from 4.3% to 4.7%. (Staff IB, 6-7.) The average 3-5 year analyst growth rate for the Gas Sample, 4.7%, was at the very high end of that range. Thus, like the Company, Staff averaged the constant and non-constant growth DCF model results. Just as each case needs to be judged on its own merits, the decision regarding which version of the DCF model is most suitable depends on the facts and circumstances at the time of the particular analysis. (Staff Ex. 8.00, 6-7.)

In Docket No. 11-0436, Staff relied upon the constant growth DCF and the CAPM to determine its ROE in its direct testimony. However, in its rebuttal testimony, Staff presented a non-constant DCF because growth rates for Staff witness Kight-Garlich's samples were no longer sustainable. The Commission chose to adopt the ROE based on the most recent information, which was the non-constant DCF. The Commission said, "[h]aving reviewed the record, the Commission finds that for purposes of this proceeding, *it would be reasonable to rely on either the constant or non-constant DCF analyses performed by Staff.* Despite Aqua's concerns, these Staff analyses appear to be theoretically sound. For the reasons given above, they use more reasonable inputs, and provide more reliable cost estimates, than do Aqua's analyses. Because they are the more current analyses in the record, the *Commission concludes that the non-constant DCF analyses contained in Staff's rebuttal testimony, 9.03% for the Water Sample (including American Water Co.) and 9.67% for the Utility Sample, are the more appropriate and reliable,* and should be used in establishing Aqua's authorized return on common equity." (Order, Docket No. 11-0436, 36.) (emphasis added).

Contrastingly, Company witness Walker included in his analysis the Risk Premium ("RP") approach in order to formulate his recommended ROE of 10.25%. Aqua was incorrect in asserting that the Commission regularly relies on the RP model. (Aqua IB, 21.) The Commission has consistently relied upon the DCF, NDCDF, or CAPM, not the RP, in determining the ROE. In fact, the Commission noted in Dockets Nos. 07-0241/07-0242 Cons. that:

The Commission again rejects the risk premium model. Insofar as it crept into decision-making in Docket No. 05-0597, that was an anomaly we will not repeat.

(Order, Dockets Nos. 07-0241/07-0242 Cons., 93-94.)

2. **Aqua's Argument that Staff's Sample Group is Flawed and is Inconsistent With Sample Groups From Prior Rate Cases is Unfounded.**

Aqua argues in its Initial Brief that Staff's sample group is flawed and is inconsistent with sample groups from prior rate cases. (Aqua IB p. 22) This is incorrect. In particular, Aqua argues that in assessing the ROE, Staff's allocation of 100% weight to the Gas Sample is inappropriate in light of Staff's approach to the determination of ROE in other related cases. (Aqua IB, 23.)

As explained in Staff's Initial Brief, however, Ms. Kight-Garlich compared the financial risk of the Gas and Water Samples to Aqua and determined that the Gas Sample is a better proxy for the cost of equity of Aqua. (Staff Ex. 3.00, 24.) Therefore, she applied 100% weight to the Gas Sample average investor-required rate of return on common equity. (Staff IB, 9) In contrast, in Docket No. 10-0194, the Commission said,

For the purposes of this proceeding, no party disputes Staff's cost of common equity methodology nor the estimates that result for Staff's Utility and Water Samples. The only issue remaining is the weight to apply to those samples' cost of common equity estimates. Based upon the record, we find that the differences in risk in between Staff's Water and Aqua on one hand and Staff's Utility Sample and Aqua on the other are too close to favor one sample over the other. We agree with Staff and the Company in this case that because of its smaller size, Staff's Water Sample group is prone to more measurement error. Consequently, we find it appropriate to apply 1/3 weighting to Staff's Water Sample and 2/3 weighting to Staff's Utility Sample. Thus, this weighting results in a cost of common equity of 10.03%. We reject the AG's argument that the Stipulation is not supported by record evidence.

(*Aqua Illinois, Inc.*, Order, Docket No. 10-0194, December 2, 2010, 22.)

For similar reasons, in Docket No. 11-0436, the Commission applied a weighting of 2/3 weight to the Water Sample and 1/3 weight to the Utility Sample. (Order, Docket No. 11-0436, 39,) In that Docket, the Commission noted, "Although Aqua objects to

Staff's proposed weighting as assigning too little weight to the Utility Sample, it does not appear to contest the rationale for Staff's proposal other than to complain that Staff's proposal is different than Staff's recommendation in previous rate cases." (Order, 34.) Likewise, in this case, the Company did not provide any evidence to show that Staff's rationale for weighting the samples was improper.

In fact, if Staff were to weight the samples as it did in either of the last two Aqua IL rate cases (i.e., Docket Nos. 10-0194 and 11-0436), the ROE would be lower than what Staff proposes here. In this case, Staff witness Kight-Garlich's overall ROE for the Water Sample is 8.78%, which is less than Staff's recommendation of 9.07% based on the Gas Sample. Thus, any weight given to the Water Sample would result in a lower ROE.

3. Aqua's Argument that Staff's Omission of a Liquidity Premium is Inconsistent with a Prior Case is Unfounded.

Aqua asserts that Staff's "failure to add a liquidity premium to its derived cost of equity is improper." (Aqua IB, 23-24) Staff disagrees. Aqua alleges that Staff's ROE analysis in the instant proceeding deviates from its approach in Docket No. 13-0079, the Mt. Carmel Public Utility Company's rate case ("GAS2013"), stating that in GAS2013 Staff utilized a similar Gas Sample to determine the ROE, but then added a liquidity premium. (*Mt. Carmel Public Utility Co.*, Final Order, Docket No. 13-0079, November 6, 2013.)

As an initial matter, this case and GAS2013 are not related cases. A liquidity premium should not be added to Aqua's cost of equity, just because it was added to Mt. Carmel's cost of equity in GAS2013. Each case before the Commission is unique and stands on its own merits. Staff has recommended a liquidity premium only for companies that do not have market traded stock, or do not have a parent company that has market traded stock, because such companies have increased transaction costs for investors. Mt. Carmel does not have publicly traded stock, nor is it owned by a company with publicly traded stock. Thus, Staff applied a liquidity premium to Mt. Carmel's cost of equity. However, Aqua is a wholly owned subsidiary of Aqua America, Inc. ("Aqua America"). Aqua America is a publicly traded company and raises all equity capital for Aqua. Accordingly, a liquidity premium is unnecessary for Aqua. In fact, Staff has never recommended a liquidity premium be applied to the cost of equity for Aqua since it was acquired by Aqua America. (Staff Ex. 8.00, 2.)

Aqua asserts that a comparison of embedded costs of debt supports the need for a liquidity premium. (Aqua IB, 24.) Aqua's comparison of embedded costs of debt is invalid. Specifically, the Company compares Aqua's embedded cost of debt to the embedded cost of debt of the Water and Gas Sample. However, such comparisons are invalid, as embedded costs for different companies reflect the cost of debt issuances that have different issuance dates, terms to maturity, and types of issue (i.e. guarantees or securitizations, tax-exempt, etc.), Likewise, the embedded cost of debt is not directly comparable to the current cost of debt. A company's current cost of debt only reflects the interest rate on the next debt issued under current financial market conditions. For example, Aqua had an embedded cost of debt of 6.69% on December 31, 2013. This embedded cost of debt reflects interest rates that Aqua locked into as long ago as 1988,

including the 10.4% Series M issued in December 1988; the 9.69% Series N issued March 1991; and the 8.0% Aroma Park series. However, Aqua's most recent debt issuances, which occurred during June of 2010 and 2012, have much lower rates of 5.22% and 3.57%, respectively.¹ (Staff Ex. 8.00, 3-4.)

Accordingly, to determine if Aqua's cost of debt² is greater than the cost of debt for the companies in the Water and Gas Samples,³ it is necessary to compare debt with similar issuance dates and terms to maturity. However, not all companies in the Water and Gas Samples have issued similar debt at the same time as Aqua. Nonetheless, Staff compared as many similar, directly-comparable issuances as it could. Table 1 below compares debt issuances by Aqua to debt issuances from companies in the Water or Gas Samples.

¹ Docket Nos. 13-0647 and 13-0647 (Cons.), Part 240 Report, April 7, 2014. This debt was issued through Aqua's parent, Aqua America.

² Aqua can access the debt markets through its parent, Aqua America. (Company response to Staff data request SK 1.24.) Thus, Staff used the cost of debt to Aqua America or its subsidiaries.

³ Aqua Pennsylvania's credit rating from Standard and Poor's reflects the "consolidated credit quality of" Aqua America. Thus, the cost to issue debt for Aqua America, should be similar to the cost to issue debt of its subsidiaries.

Table 1: Comparison of Debt Costs				
Company ⁴	Date of Issuance	Term (years)	Interest Rate	Type of Debt
Aqua	June 2012	15	3.57%	Senior Unsecured
Piedmont Natural Gas	July 2012	15	3.47%	Senior Unsecured
Piedmont Natural Gas	October 2012	15	3.57%	Senior Unsecured
Aqua Ohio	May 2013	20	3.75%	First Mortgage Bonds
Connecticut Water Service	March 2013	20	4.75%	Notes (guarantee)
Aqua Ohio	May 2013	31	4.18%	First Mortgage Bonds
AGL Resources	May 2013	30	4.40%	Senior Notes
Aqua Pennsylvania	November 2012	30	3.80%	First Mortgage Bonds
Northwest Natural Gas	October 2012	30	4.00%	First Mortgage Bonds
Aqua Pennsylvania	October 2013	32	4.61%	First Mortgage Bonds
Laclede Gas Grp.	August 2013	30	4.63%	First Mortgage Bonds
Southwest Gas Corp.	October 2013	30	4.88%	Senior Note

As can be seen in Table 1 above, Aqua cost of debt is similar to that of the companies in the Water and Gas Samples. (Staff Ex. 8.00, 4-5.) This further supports Staff's omission of a liquidity premium from its ROE recommendation and indicates that the Company's inclusion of liquidity premium is, in fact, improper.

⁴ Aqua America 2013 Annual Report, p. 54; Connecticut Water Service Inc. 2013 10K, pp. 66-67; Laclede Gas Group 2013 10K, pp. 11, 32; Piedmont Natural Gas 2013 10K, pp. 47-48, 51, 89-90; Southwest Gas Corp. 2013 Annual Report, pp. 8, 20, 29; and Southwest Gas Corp. 2012, 31-32, 58.

4. Aqua is Incorrect in its Assertion that Staff's Recommended Growth Rate is Wrong.

Aqua argues that Staff's recommended ROE also suffers from an unreasonable recommended nominal-GDP growth rate of 4.5%. (Aqua IB, 25-26, citing Kight-Garlich Dir., Staff Ex. 3.0, 9:174-10:206.) Aqua observes that its historical GDP growth rate is "significantly higher" than Staff's projected GDP growth rate. (Aqua 25-26.) That comparison is inappropriate.

First, as discussed in Staff's Initial Brief, historical data should not be used to estimate the forward-looking rate of return on common equity. (Staff IB, 11) Second, the Company fails to show that historical real GDP growth over any measurement period reflects investor expectations of long-term future real GDP growth. Further, the 15-year rolling average and the yearly historical real GDP growth the Company presented have been below the Company's 3.27% average historical real GDP growth rate for the last seven years. Thus, recent historical real GDP growth rates do not support the Company's 3.27% historical real GDP growth rate. (Staff Ex. 8.00, 10)

Finally, both of the Company's Stage 3 growth rates are based on historical growth and are not supported by professional forecasters. Projected growth rates for real and nominal GDP from professional forecasters indicate that the Company's historical real and nominal GDP growth estimates overstate the level of growth expected over the long-term and thereby overstate the Company's investor-required rate of return. (Staff Ex. 8.00, 9-10.)

Additionally, Aqua argues that the Commission has rejected Staff's methodology for calculating the long-term growth rate. The Company further asserts that its method

of calculating the long-term growth rate is consistent with the Commission's decision in Docket No. 10-0467. (Aqua IB, 25-26.), These arguments should be rejected.

First, the Company ignores the Commission's more recent decisions which approve the methodology that Staff used to determine the long-term growth rate. (Order, Docket 11-0282, 90, 122-123; Order, Docket 11-0767, 91, 111-112, and Order, 13-0079, 8, 10) Next, the Company's assertion that its estimates of long-term real and nominal GDP growth rates are appropriate and consistent with the Commission's decision in Docket No. 10-0467 is wrong. Although the Commission accepted a Stage 3 growth rate of 6% in Docket No. 10-0467, (Order, Docket No. 10-0467, 153) an economy-wide growth rate, whether 4%, 5%, 6% or even more, is not sustainable by a given company if that company is not reinvesting a portion of its earnings. For example, the growth rate per share of a company that pays out 100% of its earnings as dividends equals 0% regardless of the magnitude of economy-wide growth. In this case, Company witness Walker's calculated earnings retention ratios of 39% for his water group and 31% for his gas group are too low for his Water and Gas Sample companies to sustain the Stage 3 growth rates he employs. (ICC Staff Ex. 8.00, 11-12)

Further, the data Company witness Walker relied upon suggests that the companies composing his Water and Gas Samples are below average growth companies relative to the overall market. Specifically, relative to the overall market, which has an earnings retention ratio of 66%, the earnings retention rates for his Water Sample of 39% and Gas Sample of 31% are well below average. Further, one would expect utilities overall to earn below average returns due to the below average risk reflected in their below average betas (i.e., betas less than one), such as the 0.69 Water Sample beta and the 0.76 Gas Sample beta Company witness Walker presented.

Since utility growth is a function of both those below average earnings retention rates and below average returns on equity, one would expect *below average* growth for utilities. Thus, neither the Water nor Gas Samples can sustain either the 6% Stage 3 growth rate the Commission approved for use in the non-constant DCF in Docket No. 10-0467 or Mr. Walker's 5.71% Stage 3 growth rate.(ICC Staff Ex. 8.00, 12-13.)

5. Aqua is Incorrect in its Assertion that Size Premium is Warranted

Aqua proclaims that: "[i]t is indisputable that size plays a role in the composition of investors, and hence, liquidity." (Aqua IB, 27.) The Company claims that a size premium is necessary to reflect Aqua's increased risk due to its small size. (Aqua IB, 27.)

First, as an initial matter, the Company is wrong. It is very much in dispute that size plays a role in the composition of investors, and hence, liquidity. Secondly, Aqua's claim that it needs a size premium is unwarranted. Aqua is a wholly owned subsidiary of Aqua America. Therefore, the market for Aqua common stock occurs at the parent level, not the subsidiary level. Since the common equity of Aqua is obtained indirectly from investors through Aqua America, a much larger organization, neither Aqua nor Aqua America incur the additional costs allegedly associated with smaller companies. Aqua America can pass through common equity capital to Aqua without incurring the costs that market-traded companies comparable in size to Aqua are alleged to incur. Aqua being a small part of the much larger Aqua America does not warrant a higher cost of capital for the same reason that each division in Aqua does not have a still higher cost of capital than Aqua. (Staff Ex. 8.00, p. 17.)

Additionally, an article by T. M. Zepp (“Zepp”) cited by the Company to support its size premium actually strengthens Staff’s position that no size premium is warranted for Aqua. First the article notes that there was difficulty in analyzing the small utilities because they are not publicly traded or they do not have analyst growth forecasts. Next, the article by Zepp presents a comparison of two large and two small water companies. The two larger companies listed in the article, for which a size premium was not warranted, are California Water Service and American States Water. The recent market capitalization was \$1.14 billion for California Water Service and \$1.25 billion and American States Water. Aqua America’s recent market capitalization was \$4.4 billion. Hence, Aqua America would not be considered a small company by Zepp. Further, analyst coverage is not an issue either, since Aqua America is followed by at least ten analysts.⁵ Thus, based on the Zepp article Mr. Walker references, a size premium is not justified in this case. (Staff Ex. 8.00, pp. 17-18.)

Finally, the Commission rejected a size premium adjustment for Aqua in Dockets 03-0403, 04-0442, and 11-0436. (Docket 03-0403, Order, 43; Docket 04-0442, Order, 43-44; Docket 11-0436, Order, 37.) Specifically, in Docket No. 11-0436, the Commission said, “As indicated above, Aqua witness Mr. Walker also added a *size premium* to his CAPM results. Staff opposes this adjustment, contending, in part, that it has no theoretical basis, and that the study on which the adjustment is based is not restricted to utilities. As a general proposition, the Commission has not endorsed a size adjustment, whether applied to CAPM or otherwise, in establishing the cost of common equity. Having evaluated the evidence provided by Aqua and Staff, *the Commission*

⁵ <http://ir.aquaamerica.com/analyst.cfm>.

concludes that Aqua has not justified a size adjustment in this proceeding.” (Order, Docket No. 11-0436, 37.

6. Aqua’s Assertion that Staff’s Proposed ROE is “low” is Unfounded and Aqua’s Assertion that Staff’s Proposed ROE Would Place Aqua Illinois at a Competitive Disadvantage to Attract Capital is Not Justified.

Aqua asserts that “authorizing a low ROE percentage will make it more difficult for Aqua Illinois to access the capital necessary to continue investing in infrastructure.” (Aqua IB, 20, 29-30.) Aqua’s description of a proposed or approved ROE as “low” is inappropriate. The ROE approved by the Commission is not high or low, but the investor required return for the Company. Merely because it may not be what the Company requested does not mean that it is “low.” As discussed above, Staff has shown that the just and reasonable rate of return on common equity is 9.07%.

Aqua implies that Staff’s recommended ROE would impair Aqua’s ability to access the capital markets at competitive rates and to maintain its credit rating. (Aqua IB, 28.) However, Aqua has not provided any analysis to show that the ROE recommended by Staff would result in an ROE that would impair Aqua’s ability to access the capital markets or to maintain its credit rating.

Aqua alleges that the “ROE recommended by Staff is significantly below the authorized returns on equity for Aqua Illinois’ sister companies, Aqua Ohio and Aqua Pennsylvania, companies with which Aqua Illinois must compete for equity capital.” (Aqua IB, 28-29.) This is not pertinent.

The Company’s ROE cannot be compared to the ROE of its sister companies. The ROE is derived from current market data. The Company does not provide any data

to support that the ROE's of its sister companies were determined at the same time as Aqua. The ROE in this case must be determined by the evidence in this Docket. The Commission said it best in Docket Nos. 07-0241/07-0242/Cons. when it noted:

“Plainly, although the notion that the Utilities should enjoy at least an average ROE is superficially seductive, it is an unworkable and improper basis for determining utility returns. It would require us to abandon the course we, along with other commissions, have charted for decades. Return determinations are appropriately based on a two-pronged analysis of utility-specific financial characteristics and financial market dynamics and conditions. We have relied upon the financial models and reasonable adjustments to accomplish this. Although even these quantitative mechanisms involve some degree of subjectivity¹⁸ and can, for that reason, be manipulated, they were constructed with the intention of objectively estimating the cost of equity, not to match another utility's ROE.” (Docket Nos. 07-0241/07-0242/Cons. Order 91-92.)

“In sum, the Commission will not award the utilities the same ROE as, for example, Nicor, solely because they must compete for investment capital. If market dynamics have altered since the Nicor decision in 2005, that will be reflected in the Utilities' ROE. So, too, will utility-specific differences.”

(Order, Docket Nos. 07-0241/07-0242/Cons. 91-92.)

7. Aqua's Demand for Rates Above a Just and Reasonable Level is Not Supported by the Act.

Aqua argues that Staff's ROE Proposal serves as a disincentive to acquire troubled water and sewer systems. (Aqua IB, 29.) Staff appreciates any utility that considers acquiring financially and/or operationally troubled water and wastewater systems. Indeed, the General Assembly has recognized the public interest value and customer benefits associated with having financially stable and experienced operators at the helm of such systems. To this end, legislation was recently enacted to encourage the acquisition of such systems. See Section 9-210.5 of the Act, 220 ILCS 5/9-210.5. The Act, however, requires the Commission to establish rates for consumers that are just and reasonable, not necessarily to induce future acquisitions.

Moreover, section 9-210.5 provides an incentive to large water companies through accounting and rates based mechanisms, not by providing a company a higher ROE. The legislation does not suggest that the large water companies will also be receiving an increased ROE in order to encourage them to purchase water companies. In fact, given the incentives provided by the legislation cited, any further monies would not be just and reasonable but rather would be akin to subsidies. Those are not authorized by law. Even if the Commission were to agree with the Company's arguments here, the Commission should not grant a higher ROE on all of Aqua's rate base. In such a case, only the trouble acquisitions assets would be subject to such an incentive. The Company has not shown that such additional incentives are warranted or appropriate here.

III. RATE BASE

A. Uncontested Issues

1. Corporate Office Plant in Service

2. **Accumulated Deferred Income Taxes**
3. **Working Capital**

IV. OPERATING STATEMENT

A. Uncontested Issues

1. **Industry Association Dues**
2. **Charitable Contributions**
3. **Advertising**
4. **Depreciation Expense**
5. **Other Revenues**
6. **Incentive Compensation**
7. **Accumulated Deferred Income Tax**

Staff proposed two adjustments to ADIT: an increase of \$21,169 proposed by Staff witness Jones in connection with her adjustment to Corporate Office Plant in Service (Staff IB, 19-20) and a decrease of \$1,441 proposed by Staff witness Pearce to reflect the impact of the decrease in the Illinois state income tax ("SIT") rate from 9.5% to 7.75% effective January 1, 2015. The decrease of \$19,728 referenced by the Company (Aqua IB at 6) is the net effect of both of Staff's adjustments (Staff witness Jones' proposed decrease of \$21,169 and Staff witness Pearce's proposed increase of \$1,441). The Company inadvertently indicated that both adjustments relate to the change in the SIT rate (Aqua IB at 6). Staff agrees with the Company that neither of these adjustments is contested. (Aqua IB at 7)

8. **Income Tax Expense**
9. **Wages and Salaries Expense**
10. **Contractual Services, Other**
11. **Parent Company Service Charges**
12. **Employee Benefits Expense**
13. **Affiliate Interest Agreements (“AIA”) Updates**

B. Potentially Contested Issues

1. Rate Case Expense

Staff agrees that the central question related to rate case expense is the level of expense that is just and reasonable. Staff does not contest the amount of actual rate case expense incurred and supported by contracts and invoices through November 12, 2014, the date Aqua Kankakee filed surrebuttal testimony. That amount is ***BEGIN CONF xxxxxxxx END CONF***. (Aqua Ex. 11.2 CONFIDENTIAL) However, the Company has projected \$351,550 of total rate case expense to be amortized over a three-year period in the instant proceeding. (Aqua Kankakee IB at 9) The difference between the actual rate case expense incurred at the date of Aqua Kankakee’s surrebuttal testimony, ***BEGIN CONF xxxxxxxx END CONF*** (Aqua Kankakee IB at 11) and Aqua Kankakee’s projected rate case expense of \$351,550 is ***BEGIN CONF xxxxxxxx END CONF***. The Company noted that the November 12, 2014 actual total of ***BEGIN CONF xxxxxxxx END CONF*** did not include the following additional rate case expenses that will be incurred during the balance of the instant proceeding:

- Finalize surrebuttal testimony
- Prepare pre-trial memorandum
- Prepare for and participate in the evidentiary hearing November 20, 2014

- Prepare four rounds of briefs
- Prepare Proposed Order for the Administrative Law Judge
- Prepare Draft Order
- Analyze Commission's final Order
- Prepare compliance filing
- Prepare any post-Order pleadings

(Aqua IB at 11-12)

According to the Company's argument, the remaining balance of projected rate case expense, ***BEGIN CONF [REDACTED] END CONF*** (\$351,550 total projected rate case expense minus ***BEGIN CONF [REDACTED] END CONF*** incurred through November 12, 2014) will be used to pay legal fees for the above services which are performed by the outside law firm retained by Aqua Kankakee. As of November 12, 2014, the total fees paid to that firm were ***BEGIN CONF [REDACTED] END CONF*** (Aqua Ex. 11.2 CONFIDENTIAL). The contract between Aqua and its outside law firm limited the total legal fees for this proceeding to \$125,000 (Staff Ex. 7.00, Schedule 7.01, p. 2 of 3, line 5, column (k)). The difference between the total contract and the amount incurred at November 12, 2014 is the maximum that may be charged for the above services (\$125,000 - ***BEGIN CONF [REDACTED] END CONF***).

Staff's adjustment would reduce rate case expense by \$67,728 to a total of \$283,822 (ICC Staff Ex. 7.00, Schedule 7.01, p. 1 of 3, line 1). The Company's actual rate case expense at November 12, 2014, ***BEGIN CONF [REDACTED] END CONF*** plus the remaining balance on the contract for outside legal services, ***BEGIN CONF

xxxxxxx END CONF*** totals ***BEGIN CONF xxxxxxxx END CONF***, a balance that is less than Staff's proposed rate case expense of \$283,822. Accordingly, Staff's adjustment to rate case expense is reasonable and should be adopted.

V. HOMESERVE ADJUSTMENT TO OPERATING REVENUES

Aqua Illinois mischaracterizes Staff's basis for its proposed adjustment to impute revenues received by Aqua entities from HomeServe against rate base. (Aqua IB, 16.) Staff is not assuming that "Aqua Illinois is somehow linked to a customer's decision to renew their purchase of that product." (*Id.*) Rather, Staff seeks to credit ratepayers for any revenues that Aqua Resources might receive in the future test year that are in any way related to or derived from the sale of customer lists, which are, by statute, utility property, to HomeServe. This includes all Net Commissions and any bonuses for which Aqua Resources qualifies.

HomeServe continues to accrue benefits from the Aqua Illinois ratepayer information obtained through contracts with Aqua Resources. (Aqua 6.0, 8.) Aqua Illinois has acknowledged that there are still contracts in effect. (*Id.*) HomeServe will continue, in the test year, to make payments to Aqua Resources.⁶ Staff Ex. 5.0, (Conf.) Attachments C, D and G. Aqua Illinois remains a party to the Marketing Agreement.⁷ (*Id.*) Aqua Resources made a decision not to remit Net Commission revenues at any time to Aqua Illinois and, instead, to increase the profit of shareholders of Aqua Resources and/or Aqua America. The Commission should allocate the benefit of this

⁶ The Marketing Agreement automatically renews and all payments will continue in the test year.

⁷ Aqua Illinois has provided the entire Marketing Agreement. This agreement adds Aqua Illinois to the list but never removes it from that agreement.

existing relationship, which is the result of the provision of Aqua Illinois ratepayer information to HomeServe, to Aqua Illinois ratepayers.

At no point in time has Staff proposed a “level of revenues into the Kankakee revenue requirement that relates to *all* of Aqua Illinois’ customers” as asserted by Aqua Illinois. (Aqua IB, 16) Rather, Staff has used Kankakee Residential Customers as its starting and ending point to estimate those revenues; Staff Schedules 5.01 and 10.01 both begin with the number of residential customers in the Kankakee water division. Further, Mr. Hanley uses this same figure when he developed Aqua Ex. 11.1. Significantly, Mr. Hanley concedes that he did not properly understand how Staff arrived at its direct testimony adjustment. (Staff Cross Ex. 7.0, 1). Staff believes that this misunderstanding is the basis for Aqua Illinois’ unfounded assertion.

Staff witness Sackett estimated the Net Commission that was related to Aqua Illinois at \$74,425. This estimate was based on the actual number of ratepayers in Kankakee, just two of the nine plans currently offered to Aqua Illinois – Kankakee Division ratepayers – LeakGuard and Drainage (Staff Ex. 5.0, Attach. H, 2-3)⁸ and an estimated sign-up rate of 20% given the fact that these products have been marketed here for approximately a decade.⁹ (Staff Ex. 5.0 (Conf), 29) Aqua Illinois claims that HomeServe marketed to Aqua Illinois ratepayers for only a 22 month period. However, ***BEGIN CONF [REDACTED] END CONF*** (Staff Ex. 5.0, CONF Attach. D, 1, 5) and it seems improbable that HomeServe and Aqua America contracted to add ratepayers to the agreement but then declined to market

⁸ These plans and rates are available online at <http://www.homeserveusa.com/coverage/60901>

⁹ This was the sign-up rate for Nicor Gas customers using Gas Line Comfort Guard in Docket No. 11-0046.

services to them for 5 years. Thus, Aqua Illinois' assertions to the contrary, particularly where such assertions are based only on unvetted information provided by affiliates, should be viewed skeptically.

Although the base HomeServe offer is priced at \$5.99 per month, HomeServe has solicited its Members for additional products. (Staff Ex. 5.0, Att. H) Customers that have signed up for additional products pay more than the base amount. (*Id.*) Therefore, it is unreasonable to use only the base figure price in calculating an adjustment as Mr. Hanley has done. This method is certain to understate the adjustment.

The issue is not what the provisions were in 2012 when HomeServe ceased marketing to Aqua Illinois ratepayers using their information. Rather it is what provisions will be in effect in the test year. There is nothing in the Marketing Agreement or any of its amendments that make a special provision for Aqua Illinois net commissions to remain what they were in 2012. The Net Commission increased from 5% to 7% effective April 1, 2013. ***BEGIN CONF "XXXXXXXXXXXXXXXXXXXXXXXXXXXX

XXXXX¹⁰ XXX¹¹ XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
XXXXXXXXXXXXXXXXXXXX¹² XXX
XXxxx END CONF*** (Staff Ex. 5.0 Attachment

G, 1) Thus, the currently effective Net Commission rate is 7%. Mr. Hanley could

¹⁰ While the Staff had originally submitted this figure as confidential, the ALJ ruled it was not. (Tr. 90)

¹¹ ***BEGIN CONF XXX
XX
XXXXXXXXXXXXXXXXXXXX".END CONF*** (Staff Ex. 5.0, Attachment C, 2)

¹²***BEGIN CONF XXX
XXXXXXXXXXXXXXXXXXXX" END CONF*** (Staff Ex. 5.0, Attachment C, 3)

identify no reason why Aqua Resources would continue beyond April 1, 2013 to receive the 5% rate. (Tr. 93)

Similarly, despite the fact that these amendments were not in effect during the time HomeServe was alleged to have been marketing to Aqua Illinois ratepayers, they are in effect during the test year. Furthermore, Aqua Resources has received a bonus and is eligible to receive another. First, the Signing Bonus has already been paid but it has a five year pro-rated value.

BEGIN CONF [REDACTED] END CONF
(Staff Ex. 5.0, Attach. G, 3)

Aqua Resources does not perform any service to achieve the Signing Bonus. Rather it is based on the value of the Marketing Agreement relationship to HomeServe which includes the value of those contracts still making money for HomeServe in Kankakee. Thus, Aqua Resources benefits from Aqua Illinois being part of the territory in which HomeServe provides products. Staff witness Sackett has prorated that Signing Bonus to provide a \$***BEGIN CONF [REDACTED] END CONF***¹³ credit to Aqua Illinois ratepayers for their part in these revenues. (Staff Ex. 10.0, 13)

Additionally, the agreement between Aqua Resources and HomeServe provides for a Membership Service Agreement Bonus, which is based upon the number of active contracts. These contracts will include those in the Kankakee Division.

¹³ ***BEGIN CONF [REDACTED] END CONF*** (Amendment No. 3 to Marketing Agreement)

[illegible]

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(Staff Ex. 5.0 Attachment G, 4)

This bonus, which has not been achieved yet (Staff Cross Ex. 1, 8, Supplemental Response to DAS-5.03, dated 11/12/14, 2 (Conf.)), may be achieved in the test year.

Aqua Illinois ratepayers should get their part of the Membership Service Agreement Bonus. Staff witness Sackett has calculated a \$****BEGIN CONF xxxxx END CONF***¹⁴ credit to Aqua Illinois' Kankakee Division ratepayers with respect to Membership Service Agreement Bonus payments. (Staff Ex. 10.0, 13) Thus, the total adjustment should be \$79, 732 for the test year.

Furthermore, in Docket No. 13-0618 the Commission has ordered that Utility Services of Illinois and its service company¹⁵ account for all HomeServe revenues to the utility and they will be accounted above-the-line. “The Service Company is required to

14 ***BEGIN CONFXXXXXXXXXXXXXXXXXXXXX END CONF*** (Amendment No. 3 to Marketing Agreement)

¹⁵ USI did so by agreement. Joint Applicants Initial Brief, Docket No. 13-0618, 8-9.

include all payments received from Home Serve USA for current Illinois HomeServe contracts as revenues in all future rate proceedings.” (SECOND RIDER TO AGREEMENT, Order, Docket No. 13-0618, Attachment A) This is the model that the Commission ordered there and what Staff considers to be warranted by the record in this case. The service company in that case was the counter-party to the Marketing Agreement with HomeServe. (Order, Docket No. 13-0618, 13) Thus, it was the affiliate that was receiving revenues from HomeServe. While the Commission cannot order Aqua Resources to remit those revenues to Aqua Illinois, it is plain that shareholders should not be the exclusive beneficiaries from the sale of utility property.

Due to the nature of Aqua Resources contract with HomeServe, it cannot be determined with certainty how much HomeServe will pay Aqua Illinois in any future test year. The information Aqua Illinois supplied in this proceeding was not verified by any Aqua Illinois witness and passed through an unregulated affiliate with an incentive to filter the data in its favor. In Staff’s opinion, the evidence supports the proposition that HomeServe revenues should be credited to ratepayers whose information was sold for shareholder profit.

VI. INVESTIGATION IN AFFILIATE ABUSES

As Staff has explained in its Initial Brief, Aqua Illinois has provided testimony in this proceeding regarding when Aqua America began to provide billing and customer service to Aqua Illinois that is inconsistent with testimony it presented to the Commission in earlier proceedings. (Staff IB 45-46) In this proceeding, Aqua Illinois had stated that Aqua America has provided customer service to Aqua Illinois since the merger in 1999 and that CWC had provided those services to CIWC via a service

company prior to the merger. (*Id.*) In prior proceedings, Aqua Illinois has stated that that transition to regional call centers and centralized billing operation provided by Aqua America occurred in 2007. Staff relies on the arguments advanced in support of this proposition in its Initial Brief, and will not reiterate them here.

Aqua Illinois acknowledges that this issue has never been raised with the Commission (Aqua Ex. 6.0, 5); thus, the Commission has not specifically considered this issue. Nevertheless, Aqua Illinois argues that the Commission has “considered” the provision of these services without them being contested. (Aqua IB, 37) This however, is not dispositive; the Commission should consider the issues before it in this proceeding.

Moreover, the Schedule C-13: Summary of Affiliated Interest Transactions shows that Aqua Illinois and CIWC have provided assertions in each of the referenced cases, stating in each that these services were provided “pursuant to service agreements approved in Dockets 85-0491 and 98-0632.” Thus, even if the Commission were to rely on past decisions or more accurately, upon decisions in which the issue was not presented, the Commission should not do so here, where such decisions were the product of erroneous information.

Finally, while there is insufficient evidence as to the amount of any adverse rate impact to Aqua Illinois ratepayers as a result of Aqua America’s provision of customer and/or billing services to Aqua Illinois, the financial impact of this provision should be subject to further investigation. The investigation recommended by Staff will allow the Commission to identify adverse impacts resulting from Aqua Illinois’ transactions with its affiliates.

VII. RATE DESIGN

VIII. CONCLUSION

WHEREFORE Staff of the Illinois Commerce Commission respectfully requests that its recommendations be adopted in their entirety consistent with the arguments set forth herein.

Respectfully submitted,

/s/

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